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C O N F I D E N T I A L SECTION 01 OF 02 RIGA 000729

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SUBJECT: WHY LATVIA SHUNS DEVALUATION

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Classified By: Ambassador Charles Larson, for Reasons 1.4 (b) and (d)

¶1. (C) Summary. As Latvia currently negotiates IMF and EU financial assistance, government officials have indicated their willingness to embark on new levels of fiscal pain and administrative reorganization. They draw the line, however, when it comes to Latvia's fixed exchange rate policy. The Lat's peg to first the SDRM and now to the Euro is credited for defeating post-independence hyper-inflation and laying the foundation of confidence and sustainability that has provided economic growth and entry into European and Transatlantic alliances. Given Latvia's dependence on imports, obligations to Euro-denominated debt in both private and business arenas, and Latvia's desire to maintain confidence in the Lat until adoption of the Euro, talk of altering the currency's peg is a non-starter. Given the pain it would cause across society (from homeowners not able to pay mortgages to increased un-affordability of food, energy and other imports), the blow to confidence in Latvia's financial sector, and the likely limited benefits to exports and competitiveness, there is no political will or justification to undertake a devaluation. End summary.

¶2. (C) Latvia's discussions with the IMF and EU are ongoing regarding financial assistance to shore up Latvian foreign exchange reserves, bolster the local financial sector, and stabilize the country's macroeconomic situation in general. As we have spoken with key government officials, they describe Latvia as in agreement with the IMF and EU on all potential conditionality that may be place on aid, apart from considering altering the Lat's peg to the Euro. Though we are told it was discussed in the initial four days of talks with the IMF, great efforts (apparently successful) were made to convince the Fund not to request changes to monetary policy. This stems greatly from Latvia's pride in always having maintained the Lat's peg. However, the primary deterrent to devaluation is the widespread harm it would cause across society, which in exchange for almost no benefit that could be identified by the common person, makes such a move politically unthinkable.

¶3. (U) Latvia is a small, import-dependent and foreign-trade-reliant economy. In addition, since Latvia's accession into the EU, economic growth and increases in the standard of living have been heavily based on rapidly expanding credit, most of which is not denominated in Lats. 85% of all residential loans are denominated in Euros, as are much of the loans that have paid for cars and consumer product imports. Latvia also imports much of its food and energy, and the high levels of inflation of the last two years have already been a significant financial burden to many Latvians. If the Lat were to be devalued, residents would immediately lose the purchasing power they need to keep paying their mortgages (worsened by the fact that many people took out mortgages at the height of the now past housing

boom) and obtain basic necessities. The resultant increase in illiquidity would affect the stability of the domestic banking system and retail sector. Increased debt service costs in both sectors could lead to deterioration of banks' asset quality, which would diminish their capital adequacy and add to the instability of the financial system.

¶4. (U) The benefits normally associated with devaluation in big economies, increased exports and competitiveness, would likely be minimal here, say experts, as Latvia is not resource rich and is generally a "price-taker" in international markets. Even Latvia's export-oriented businesses may not see benefits, as many are reliant on imported energy and component factors which would be pushed up in price. GOL officials point out that Latvia's current account deficit, which at its peak of 26% of GDP was used to justify calls for devaluation, has been significantly reduced (down to 15.6% of GDP in the second quarter of 2008) as the economy has slowed, without resorting to alterations in the Lat's peg.

¶5. (U) On the government side, the GOL worries that a weakened Lat would send a negative message to foreign investors, hindering the ability of both businesses and government to attract financing and investment. The Bank of Latvia has said that selling of Lat-denominated T-bills and other paper would be undermined, and the loss of confidence in the Bank's management of the Lat would make any new exchange rate mechanism potentially impossible to support. The overall loss of investment and outside funding, in the Bank's view, would lead to a tightening of local credit conditions, stagnating economic growth and spillover effects in Latvia's Baltic trading partners.

¶6. (C) Comment. Given the doomsday scenario devaluation would

bring, and the limited benefit expected from breaking the Lat's peg, it is an easy political calculation that the government will accept almost any level of fiscal tightening and hardship rather than face voters' wrath in the aftermath of Lat devaluation. The ruling coalition has largely escaped blame for mismanagement or inaction during the overheated economy prior to 2007, and it has faced limited protests as it tightened its belt in passage of the 2009 budget. Indications are that the government is willing to revise the 2009 budget with anywhere from 200 million to 400 million Lats ($364-728 million USD) worth of further cuts to avoid touching the Lat. Given Latvia's lack of strong unions and public popularity of the Lat's stability, this course appears to be the best one forward as the government looks to face voters in next year's local government elections.
LARSON